City of Rockville Retirement Board

December 8, 2006

PRESENT: Allen Gorrelick, Chairperson; John Sverha, Citizen Member; Anita McCombs, AAME Representative; Joe Pritchard, Union Representative, Robert Dorsey, Councilperson; Catherine Tuck Parrish, Deputy City Manager. Also in attendance were Gavin Cohen, Executive Secretary to the Board; Rich Hajewski, Director of Personnel; Mary Johnson, Personnel Administrator; Tim Peifer, Financial Systems Manager, Alison Putnam, Mike Dulaney, and Debbie Frederickson from the Principal Financial Group, as well as George Kiriakos, Robert Liberto, Rick Johnson, and Frank Farentino from Segal Advisors.

ABSENT: Sgt. Tim Marsh, FOP Representative

The meeting commenced at 10:10 a.m. and began with introductions.

I. Review of Actuarial Valuation Report Dated April 1, 2006:

Mr. Dulaney began by explaining that changes were made to the report to make it a more standard report according to GASB standards. He said that the changes were made to make the report easier to read with less detail. Benefits that were not creating liabilities for the pension plan such as the medical subsidy and thrift match were removed. The new format of the report makes it easier to comply with GASB reporting. There is a slight change in cost method. The "safety margin" was replaced with expected interest to the end of the plan year. It will be easier to make further changes going forward to better meet our needs.

The recommended annual contribution for the 2006 plan year is $1.6 million for the two groups, Police and Non-Police. This is made up of three things, normal cost, amortization of unfunded liability and interest to the end of the year. Normal cost is the cost of benefits accruing during the plan year. Amortization of Unfunded Liability is paying for plan experience that is different from what is expected.

The 2006 Actuarial Valuation Major Events were the Unfunded Actuarial Liability stayed the same. The market value of the plan assets increased approximately 11.3% during the 2005 plan year. The actuarial value of assets increased almost to the 7.75% expected. There was a COLA increase in retiree's benefits effective January 1, 2006. All other plan experience was very close to expected.

He went on to talk about the deferred asset gains and losses. The market value of assets returned $7.1 million less than expected in 2003. Principal has spent the last four years working in $1.7 million every year into the plans assets for funding. Mr. Sverha questioned if you could choose more than four years to spread out recouping the assets? Mr. Cohen responded that the number of years is not mandated. Mr. Cohen asked why not longer? Mr. Dulaney responded that it works out to do it this way so that you don't see spikes and you keep the plan balance smooth. Mr. Sverha questioned if the worst drop was in 2002? Mr. Dulaney said it has already worked its way out. He remarked that the actuarial value of assets are less that the market value of assets and that you will finally see deferred gains showing up. He went on to discuss the chart on page 10, Assets vs. Liabilities Nonpolice. He said that this chart demonstrates that the City is now in a situation to take a long-term view. Mr. Sverha asked if the reason was because in the Public sector you can raise taxes. He said that it is the same thing for the Police. The accrued benefits are fully funded and the others are not.

Page twelve of the report is the history of non-police contribution percentages. The funded status of the plan should improve and funding contributions decrease. Mr. Cohen remarked that there is a negligible difference between 2003 and 2006 and thinks smoothing is working really well.

Page 13 is the history of Police contribution percentages and the Police normal cost is 8.2% of pay.

Page 14 is the list of increase in unfunded actuarial liability.

Page 15 is the mortality assumption table of plan. It indicates that men are expected to live longer. Mr. Cohen asked does that mean that the plan table needs to be changed? Mr. Dulaney responded that at some point you would want to change the mortality table of the plan. Mr. Sverha asked what the chair thought. Mr. Gorrelick responded that he did not know enough about the issue and that it makes sense to make the change now due to the future outlook of the unfunded liability. Mr. Dulaney said if changed it would be April 1, 2007. Ms. Tuck-Parrish clarified that it would not take effect until April even if they voted today. Mr. Dulaney confirmed that. Mr. Cohen asked if the Board would like to make a recommendation on the discussion now. Mr. Gorrelick said that it calls for a motion to make the change to ask the actuary to use the new mortality table in the calculations for 4/1/07 Valuation Report. Councilperson Dorsey said he would and Mr. Sverha seconded it. All were in favor. Mr. Gorrelick said that they also had to approve the change in the interest and safety margin. Mr. Sverha made the motion to make the two changes. Councilperson Dorsey seconded it. All were in favor. Mr. Cohen said it does come through in the back of the valuation report what was explained is on VII-4 and is incorporated as part of the valuation.

Mr. Dulaney informed the Board that this is the last valuation he will be doing and that Principal has assigned Mike Clark from Pittsburgh to do the future actuarial valuations. He stated that he has enjoyed working with the City.

II. Asset Allocation Study/Asset Liability Model Study DB Plan:

Mr. Cohen started by saying that an asset liability study has never been done by the Plan and that we have the capability of doing it. Mr. Johnson from Segal Advisors gave the presentation. He explained asset/liability modeling is projecting both pension plan assets and plan liabilities over time to gain better knowledge of likely costs and in particular provides estimates as to where the System may be heading under various scenarios with respect to funding, annual liquidity and actuarial accrued liability. He stated that none of the materials used to illustrated the model were representative of our plan. He said there are two types of ALM projections. The first one is Deterministic and is used for certain things such as impact of plan changes, changes in mortality table and contributions going out. With the Deterministic approach the projections will be projected over multi-year periods modeling a limited number of assumptions and scenarios. The other type of ALM projection is the Stochastic approach. In the Stochastic approach multiple random economic scenarios are run. Five hundred random assorted simulations can be run each year for 20 years. Mr. Liberto said no two scenarios are the same. Mr. Johnson continued to go over the report. The Stochastic adds the notion of risk and variability to expected results by recognizing full range of investment return possibilities. It shows ranges of results and related probabilities/risks. It is still dependent on validity of assumptions. It is a more useful guide for long-term planning. It helps fulfill Trustees' fiduciary obligations. This modeling is used by other public pension funds. Every Stochastic modeling starts with an Actuarial Valuation and that would be the starting point. The Actuarial Valuation is a "snapshot" measurement of the pension plan. It is based on one set of assumptions. There are no liabilities for future participants. It provides a measure of where the plan is now. It uses past experience to make a projection about the future and develops the cost allocated to the next year. It is limited to a short-term view. ALM modeling gives a long-term view of the health of the plan. ALM modeling work will be done very closely between actuarial folks and investment folks. Mr. Kiriakos said that ALM modeling is a very useful tool and can be used for real life situations. Mr. Johnson said that this modeling and theory has been around for many years and used mainly by highly aggressive corporations. Discussion continued as to how often it would be done and Mr. Kiriakos said that it could be done once every three to five years. He said that the cost would depend on the size of the spreadsheet. Mr. Cohen stated that the board is looking for a model such as this to be used with the policy guidelines of 50% in Domestic Equities, 15% International and 35% Fixed Income. Mr. Gorrelick asked for this item to be readdressed at a future meeting.

III. Review of Quarterly Performance Report July 1-September 30, 2006:

Mr. Kiriakos went through the Analysis of Investment Performance Report. The Feds managed to slow down the economy. Gross domestic product was down to about 1.6% in the third quarter and it usually runs about 3%. We are running about half of where we should be with regard to domestic productivity. It kept the Feds from raising interest rates. The S&P had one of its better quarters in nine years, with a 5.7% return for the third quarter of the year. The other observation is a rotation out of small cap into larger cap names during the period. The reverse had been true earlier in the year. Smaller cap stocks were leading the way and larger caps were lagging, but now if you look at the year to date period you will find those results looking a lot more alike. Small caps still has some advantage but nowhere near as much as it had if you had looked at this in June or in March. Value stocks continue to remain more robust than growth stocks. Technology stocks did have a fairly decent run for the latest quarter. They have a lot of ground to make up from lawsuits earlier in the year. Energy stocks were good in the first two quarters, but did not do well in the third quarter. If your manager hung on to the energy gains through the third quarter then you would have taken a severe beating. The energy sector was a big underperformer. These days one of the things we are starting to see more than ever before is the influence of Hedge Fund activity on the capital markets and mainly due to short selling particularly with regard to the energy sector. During the third quarter the bond market was looking forward to a favorable environment. It had a return of about 7%, better than what went on in the stock market. Mr. Sverha inquired about housing. Mr. Kiriakos responded that commercial real estate is up as much as 30%. Residential housing is starting to see the brunt of the end of refinancing. The housing market is going to be very geocentric. Where you are is going to determine whether your market continues to rise or flatten. For example, on Long Island there is nothing that is going to slow the market because they are running out of land. There are places that are overbuilt such as condos in Florida. The International stocks have had a fairly decent run, but have slowed down during the quarter. US stocks have done better than International stocks for the quarter.

Mr. Kiriakos went on to relay what went on with our funds. He started with the asset allocation chart on page 8. It shows the market value at the end of September to be $58 million and at the end of June to be $56 million. So you have about a $2.2 million differential. The fund was worth more at the end of September than it was at the end of June. In asset allocation there was 55% in the large cap portfolio, 14% in the international and 31% in the fixed income , which is not far off our target of 50,15, and 35. Mr. Gorrelick asked when you would recommend rebalancing? Mr. Kiriakos stated that you could wait to see where the plan is at the end of the year. Your average annualized return over the three-year period is 10.5% for the whole pool of assets. The large cap portfolio is staying in line with the S&P 500. The international portfolio added value on an overall basis for the last three to five years. The fixed income portfolio has also done a very nice job. Mr. Sverha said it was a very good review.

IV. Review of Thrift Plan:

Mr. Liberto started with saying the performance overall was pretty good. This is a participant driven plan. Assets went up about $600,000 in the period. That increase was comprised of about $250,000 in contributions coupled with just over $350,000 in investment gains. As of September 30,2006, the Principal Large Cap Stock Index Account held the largest percentage of Plan assets at 17.5%. The largest percentage of new contributions received during the three months that ended September 30, 2006 were the Principal Money Market Account at 27.3%, the Principal Large Cap Stock Index Account at 12.9%, and the Principal Guaranteed Interest Account at 11.4%. The allocation of participants is excellent. There is not much money movement between funds. The bulk of the money sits in the S&P 500. There are a lot of conservative investors. Very little changes in the asset mix between the June and September numbers. People are more conservative in the new money than the old money. Mr. Gorrelick asked Ms. Putnam if she accepted forms without an asset allocation chosen? Ms. Putnam responded that she doesn’t and that Ms. Johnson normally works with the employee to select one. There is a nice diversification of allocation in participants in funds. Our plan is more diverse than some corporate plans. There are only 59 people in one plan and 47 of them are in the money market. Mr. Liberto said it is one of the best plans he has seen. The Principal Guaranteed Interest Account underperformed for the three-month period that ended September 30, 2006. The Principal Money Market Account matched the three-month US Treasury Bill for the third quarter of 2006. The Principal Bond & Mortgage Account posted a return of 3.8% for the third quarter of 2006. The Principal Stock Emphasis Balanced Account underperformed the Policy Index for the three-month period ended September 30, 2006, but outperformed the benchmark for the year-to-date and one year periods. The Vanguard Windsor II Fund outperformed the Russell 1000 Value Index return of 6.2% for the three months ended September 30, 2006. It is a good large cap value fund. The Principal Large Company Value Account underperformed the Russell 1000 Value Index for the third quarter of 2006 yet placed above the median of the large cap value mutual fund universe. The Principal Large Cap Stock Index Account slightly underperformed the S&P 500 Index over all study periods analyzed and posted returns within the 0.31% expense ratio of the fund. The Principal Large Company Growth Account underperformed the Russell 1000 Growth Index for the recent three-month period ended September 30, 2006. The Principal Large Cap Growth I Account underperformed the Russell 1000 Growth Index for the third quarter of 2006. The American Century Small Cap Value Fund underperformed the Russell 2000 Value Index for the three months ending September 30, 2006 and ranked in the top percentile of the small cap value mutual fund universe. It was recommended that this Fund remain on the watch list while Segal continues to monitor results. The Principal Small Company Value Account underperformed the Russell 2000 Value Index for the latest period ended September 30, 2006. The Vanguard Explorer Fund outperformed the Russell 2000 Growth Index decline of –1.8% for the third quarter of 2006. The Principal Diversified International Stock Account underperformed against the MSCI EAFE Net Index for the third quarter of

2006. The reason for the underperformance is poor stock selection. The expense ratios are very competitive and on the low side. Low volatility overall in this portfolio.

Took a break for lunch until 1:00

IV. Review of Thrift Plan: (continued)

Mr. Cohen started with saying that we asked Segal to review all the funds and come up with some recommendations for the Thrift & Supplemental Plan. Mr. Liberto put together a memorandum and he went through it and gave his recommendations. He already discussed the Principal Guaranteed Interest Account and does not recommend doing anything with that, but from time to time take a look at it and see if there is something else we might want to do. He said he was asked to look at any two funds that were in the same class. He said we have several. He said Segal looked at the Vanguard Windsor II Fund versus the Principal Large Company Value Account and Segal's choice would be the Vanguard Windsor II. On an annualized basis the Fund outperformed the Principal Large Company Value Account four out of the five past years. Segal recommends terminating the Principal Large Company Account and mapping the assets into the Vanguard Windsor II Fund. The next to look at was the Principal Large Company Growth Account vs. the Principal Large Cap Growth Account. Segal's choice would be to keep the Principal Large Company Growth Account. The Fund has a lower expense ratio and on an annualized basis the Fund outperformed the Large Cap Growth Account three out of the past five years. Segal recommends terminating the Principal Large Cap Growth Account and mapping assets into the Principal Large Company Growth Account. The next to look at was the American Century Small Value Fund Inv. vs. the Principal Small Company Value Account. Segal's choice would be the Principal Small Company Value Account. The Fund has a lower expense ratio. The Principal Account has outperformed the American Century Fund for all study periods, except the most recent quarter. The American Century Fund is currently on the Plan's "watch list". Segal recommends terminating the American Century Small Value Fund and mapping the assets into the Principal Small Company Value Account. He went on to say in reviewing the current Plan investment structure they identified one asset class that you may wish to consider adding to the Plan's options. The Mid-cap category is not represented in the Plan. Segal recommends adding a Mid-cap core option in order to reflect all asset classes that are normally offered in a participant choice program. He then said they were asked to review the Principal LifeTime Funds as additional offerings to the Plan. They reviewed the performance and portfolio of each option. They liked the portfolio construction with a good mixture of stocks and bonds. Performance for all study periods was strong. The Pension Protection Act of 2006 (PPA 06) has identified balanced or Life-Cycle options as acceptable default funds in a participant directed plan as it pertains to the safe harbor under 404(c). Segal supports the addition of the Principal LifeTime Funds in the Plan.

Mr. Sverha made the motion to follow the recommendations made by Segal:

1) eliminate the poor performing of the two funds where there are two funds in the same area and one is performing worse than the other
2) add the Life Cycle Funds offered by Principal
3) add a Mid Cap Blend Fund
4) employees have from the time they are initially notified until 3/31/07 to decide if they want to make investment changes prior to closing of funds and mapping funds

Councilperson Dorsey seconded the motion.

Mr. Liberto said you have to think about time frames and inform the participants of these changes. Mr. Hajewski said the important thing is that they are notified and that they understand why the changes are being made. Ms. Putnam said that April would be a good time frame. Mr. Cohen and Ms. Putnam decided they could decide later who would do the notification and how and when.

Mr. Liberto moved onto the draft of the Investment Policy Guidelines. Mr. Cohen pointed out that he included the Old Policy Investment Guidelines in the packet for some frame of reference and you can just look at the new one and see just what you have been discussing now. Mr. Liberto said that sometimes they can work off the old guidelines and just modify them a bit, but these were really written like Pension Guidelines and this is a Defined Pension Plan. We decided to rewrite them to put them in line with this type of plan. How we set this up was with an introduction and objective of the plan and all the things you want to accomplish with these guidelines. This should not change once you sign it and the only thing would be to update the selected investment options from time to time. Mr. Liberto went through the document and explained each section. He pointed out each fund is net of fees. The section "Investment Option Evaluation" is an important piece since just discussed some funds to eliminate and this gives you options relating to any funds in the future or today. These guidelines are more appropriate than what you had before and are here to protect you and your roles as fiduciary. Ms. Tuck Parrish moved to accept this document with the changes mentioned. Mr. Sverha seconded the motion. All were in favor.

V. Discussion and Recommendation of Retiree COLA for 2007:

Mr. Cohen said the final item is a COLA of 1.5% to go into effect January 1, 2007 for retirees who were receiving benefits prior to January 1, 2006. He stated that what he did this time he put a couple criteria that he looked at. There is not one particular item, but a whole range of things such as the CPI, what the City could afford, and what we have done in the past. It seems that 1.5% falls right in that criteria. This would be staff's recommendation. Mr. Gorrelick said that looking at the Actuarial Report that last years added $220,000 to the unfunded liability. Councilperson Dorsey said it seems that the time we did not give it the world did not end. Mr. Hajewski said that it is not normally brought to the Retirement Board if it is not doable. He also stated that it does become an expectation if you keep giving it. Mr. Hajewski stated that the years we did not give it were when the budget wouldn't allow it. There is a concern that it could create a pattern. Mr. Gorrelick stated that maybe we should skip a year until there is a high CPI. Mr. Hajewski said that maybe the communication should include that we could afford it this year, but that it is never a guarantee to be given every year. Mr. Gorrelick motioned to accept the 1.5% as recommended. All were in favor. Mr. Cohen said it would go before the Mayor and Council on December 18, 2007 for approval.

VI. Discussion for Future Agendas:

The first four items were items we couldn't get to at the last meeting. Mr. Gorrelick feels they should go on the June meeting.

Ms. Putnam and Ms. Frederickson said they would be happy to take care of the Pension Protection Act of 2006. Mr. Gorrelick said that Segal should take care of the first two items. He said that all of the rest of the items should go on the June meeting. Mr. Gorrelick mentioned that Mr. Cohen should get with Segal before June to decide what the educational topics would be.

Ms. Tuck Parrish made the motion to adjourn at 2:15 p.m. and Mr. Gorrelick seconded it. All the rest were in favor.